

1 29. CLECs have become ~~marginalized because~~ they do not ~~own~~ the ~~strategic assets~~
2 necessary to compete, and ~~must~~ instead ~~rely~~ upon the ubiquitous Bell network, a network that
3 remains largely closed to new ~~entrants~~, Sections **251 and 252** notwithstanding. There has been
4 carnage among CLEC stocks, and numerous competitive LECs have filed or are on the verge of
5 filing for bankruptcy.⁴⁵ From a financial perspective, many CLECs ~~operating~~ within the District
6 are experiencing a major economic downturn. The optimistic tone of Ms. Johns' declaration
7 would have one believe that CLECs are ~~stronger than~~ they have ~~ever been~~ in their ability to
8 capture market share, when in fact ~~just~~ the opposite is true.

9
10 30. CLECs have continued to have financial difficulty in producing revenues as well as
11 obtaining financial suppon. This situation is reflected in a May **8,2002** Morgan Stanley **Dean**
12 Witter report, in which the analysts note that "revenue **growth** continues to ~~be~~ impaired by
13 disconnects and **bankruptcies**."⁴⁶ In addition, the analysts state that, "[w]e are cautious on
14 competitive services. Our industry weighting is due to the over-leveraged balance sheets, lack of
15 profitability and execution difficulties endemic to the **group**."⁴⁷

45. In addition to the carriers noted earlier in my testimony, the lengthening list of CLECs that have filed for bankruptcy protection during the past two years also include notable carriers such as McLeod, Intermedia, Global Crossing, **GST Telecomm Inc.**, Net2000 Communications, ICG Communications and Winstar. According to the Wall Street Journal, there are only **80** CLECs in operation today, down from 330 at year-end **2000**. See "FCC's Powell Says Telecom 'Crisis' May Allow a Bell to Buy WorldCom," *Wall Street Journal*, July **15,2002**, at A1, provided in Attachment **OPC A-3**.

46. Morgan Stanley Dean Winer, Equity Research: ~~North~~ America, Industry: Competitive Communications Services, Time Warner Telecom, May **8,2002**, at 1.

47. *Id.*

31. The sharp drop in CLECs' overall ~~market~~ capitalizations over the past few years lends further support to the notion that CLECs face a serious uphill battle with respect to gaining share in the local exchange markets. As illustrated in Table 2, many of the carriers identified by Ms. Johns that still provide service have experienced a precipitous drop — in the range of 86% — in stock price and market capitalization over the past 36 months.

TABLE 2							
CLEC Market Capitalization							
Company Name	September 30, 1999			September 24, 2002			% Change From 9/30/99 to 09/24/02
	Stock Price	Shares Out-standing	Market Cap	Stock Price	Shares Out-standing	Market Cap	
Adelphia	\$28.00	51.42	\$1,439.67	Filed for chapter 11 on June 25, 2002			n/a
Allegiance	\$63.00	64.86	\$4,086.48	\$ 0.90	123.40	\$ 111.10	-97%
AT&T Corp	\$47.44	3,195.63	\$151,582.86	\$ 11.95	3,850.00	\$ 46,000.00	-70%
Commonwealth Tele	\$44.00	22.11	\$972.77	\$ 35.02	23.50	\$ 821.90	-16%
Connectiv	\$19.63	87.27	\$1,712.58	\$ 25.33	88.80	\$ 2,250.00	31%
CoreCom	\$37.19	72.05	\$2,679.43	Delisted from Nasdaq as of June 2002			n/a
CTC Communications	\$16.44	14.55	\$239.24	\$ 0.12	27.40	\$ 3.28	-99%
CTO	\$47.00	19.93	\$936.49	\$ 14.10	18.70	\$ 263.30	-72%
Intermedia	\$25.00	50.99	\$1,274.64	Acquired by WorldCom as of 8/8/01			n/a
Focal	\$23.94	60.65	\$1,451.72	\$ 0.50	4.94	\$ 2.47	-100%
Global Crossing	\$26.50	794.77	\$21,061.42	Filed for chapter 11 on January 28, 2002			n/a
GST Telecomm Inc	\$7.03	37.71	\$265.18	Filed for chapter 11 on May 17, 2000			n/a
Northpoint	\$24.31	125.24	\$3,044.88	Filed for chapter 11 on January 16, 2001			n/a
IOG Communications	\$15.56	47.34	\$736.77	Filed for chapter 11 on November 14, 2000			n/a
Level 3 Communications	\$52.22	341.08	\$17,810.58	\$ 3.69	406.40	\$ 1,500.00	-92%
Worldcom	\$76.88	1,880.22	\$144,541.84	Filed for chapter 11 on July 21, 2002			n/a
RCN	\$49.69	76.18	\$3,785.42	\$ 0.68	109.70	\$ 74.60	-88%
Sprint	\$54.25	785.21	\$42,597.39	\$ 9.56	979.00	\$ 9,360.00	-78%
Time Warner	\$20.88	104.54	\$2,182.75	\$ 0.95	114.80	\$ 109.10	-95%
Winstar Comm Inc	\$39.06	54.93	\$2,145.89	Filed for chapter 11 on April 18, 2001			n/a
XO Comm/Nexel	\$61.38	315.45	\$19,360.84	Filed for chapter 11 on June 17, 2002			n/a
Total CLEC			\$423,918.84			\$ 60,495.75	-86%
Source: carrier 10Q reports, www.thedigest.com/stocks/							

1 32. A similar analysis of stock performance for companies in the telecommunications sector
2 has been undertaken by **TR Daily**. Initiated in November of 2001 with a baseline value of 1,000.
3 the publication developed a telecom index composed of telecom service provider and equipment
4 supplier stocks. Since that time, the **TR Daily** index has demonstrated similar large drops in
5 value: As of September 24, 2002, the index had dropped to 519.83, which correlates to a 48%
6 decrease in the past ten months alone.⁴⁸ By comparison, the Dow Jones Industrial Index had
7 dropped by only 17% and the broad market S&P 500 had dropped by 24%⁴⁹ over that same ten
8 month period.

9
10 33. The dramatic decreases in CLEC share prices indicate that (1) investors have less
11 confidence in these companies' ability to succeed with business plans premised upon competing
12 with ILECs; and (2) the companies themselves now will have much more difficulty attracting
13 capital with which to pursue their business plans. Telecommunications is an industry requiring a
14 substantial amount of up-front investment, and a lack of capital with which to pursue market
15 entry will surely adversely impact a carrier's ability to gain market share, and may well drive
16 some companies out of business or into Chapter 11. In fact, industry officials state that
17 "Telecom firms have run up total debts of around \$1 trillion." and that the telecommunications

48 Telecom Woes Hit Hardier Stocks. TRDaily Telecom Index Falls 1.5%," **TR Daily**,
September 24, 2002

49 <http://finance.yahoo.com/q?d=t&s=DJI>; <http://finance.yahoo.com/q?d=t&s=GSPC>.

1 industry "faces years of painful reorganization. as the oversupply of capacity built during the
2 boom years is brought into line with demand. and the mountain of debt is **restructured**."⁵⁰

3
4 34. Approval of Verizon's entry into the long distance **market prior to the development of**
5 **effective, price-constraining competition in the local market** exposes consumers and competitors
6 in the District to several serious risks that this commission should consider when determining if
7 Verizon entry into the District's interLATA market would further the public interest:

8
9 (1) The risk that in the District, as in other Verizon in-region areas, Verizon will engage in
10 anticompetitive behavior using the Verizon local monopoly legacy customer base to
11 cross-subsidize its long distance offerings. This behavior harms local service customers
12 and gives Verizon Long Distance an unfair advantage when developing long distance
13 pricing plans.

14
15 (2) The risk that — over and above the continued monopolization of the *local* market —
16 Verizon would be able to utilize its joint marketing relationship to extend its local
17 monopoly into the adjacent long distance market, thus **reducing** the level of competition
18 that presently prevails with respect to long distance service;

19
20 (3) The risk that the "incentive" for Verizon to open its market to competition, currently
21 provided by the Section 271 "carrot," will evaporate if interLATA authority is obtained.
22 Thus, the Company may "backslide," slowing or reversing altogether the market-

50 "The great telecoms crash". *The Economist*, July 20, 2002, at 9.

opening measures it had pursued in order to satisfy **the** Section **271(c)(2)(B)**
"competitive checklist." **unless** the Commission **adopts** effective **self-enforcing**
mechanisms **that** provide **an** ongoing incentive for **Verizon to** remain in full compliance
with all checklist items: and

(4) The result: **Entry** by new carriers into the District's local market would **be** discouraged.
existing competitive **local** service providers (**CLECs**) would **exit the** market. long
distance carriers would also **exit the market as** Verizon's long distance market **share**
grows. and prices for **both** local and long distance service would inevitably increase.

SECTION 272 SEPARATE AFFILIATE REQUIREMENTS

Recognizing that satisfaction by a BOC of the 14 point "competitive checklist" does not by itself diminish the BOC's market power with respect to local and access services, Congress has required that following Section 271 approval a BOC operate its in-region long distance business out of a structurally separated affiliate, and adopted a five-part code of conduct delineating permissible interactions between the BOC and the long distance entity.

35. Even in the event that the FCC ultimately determines that Verizon DC has satisfied all of the 14 requirements of Section 271(c)(2)(B), that does not imply that the Company no longer possesses market power in the DC local service market. In fact, there is no "market power test" in either Section 271 or in the FCC's rules implementing it. As such, a determination that a BOC satisfies all 14 "checklist" elements and, based thereon, a grant of in-region long distance entry may not be construed as indicating any diminution of the BOC's market power with respect to local and access services.

36. Indeed, Congress clearly recognized that a BOC would retain substantial local service market power when first entering the long distance market. Congress therefore imposed a number of additional requirements governing the BOC's conduct as both an incumbent LEC and a long distance service provider. Specifically, Section 272 requires that, for at least three years following its entry into the in-region long distance market in any state and longer if extended by the FCC, the BOC (1) operate its long distance business out of a structurally separate affiliate, and (2) established a specific code of conduct to govern the interactions between the BOC ILEC entity and the long distance affiliate.

1 37. The purpose of the Section 272(a) ~~separate~~ affiliate requirement and the Section 272(b)
2 code of conduct was *and is* to forestall the potential for ~~discriminatory~~ and anticompetitive
3 conduct arising out of the ability, *as an economic matter*, for the BOC to ~~extend~~ its market power
4 in the *local* telecommunications market into the adjacent long distance *market?*" In making its
5 determination *as* required by Section 271(d)(3)(C) that "~~the requested~~ authorization is consistent
6 with the public interest, convenience, and necessity," the Commission should determine that
7 Verizon will be in compliance with the ~~separate~~ affiliate requirements of Sections 272(a) and (b).
8 The Commission should make that determination in the context of the history and background
9 that gave rise to the separate affiliate requirement in the 1996 federal legislation. That history
10 begins with the US Department of Justice's 1974 antitrust case *against* the pre-divestiture Bell
11 System" in which the DoJ alleged, *inter alia*, that the Bell companies ~~were~~ using their local
12 service monopoly to prevent competition in the adjacent long distance market.

13
14 38. The *Modification of Final Judgment ("MFJ")* the 1982 Consent Decree under which . .
15 the former Bell System was broken up and the Bell Operating Companies ("BOCs") were
16 divested from AT&T,⁵¹ prohibited the divested BOCs from offering *interLATA* long distance
17 services. *As* I discussed earlier, this *structural remedy* was adopted in order to prevent the BOC
18 local service monopolies from using their monopoly market power in the local services market to

51. *Conference Report on S. 652, Telecommunications Act of 1996* (House of Representatives- February 01, 1996) Congressional Record, H1171.

52. *United States v. Western Electric Company, Inc., et al.*, Civil Action No. 74-1698 (D.D.C.).

53. *United States v. Western Electric Company, Inc., et al. op cit.*, footnote 6.

1 block competition in the adjacent long distance market. Since the BOCs were themselves
2 precluded from providing long distance services, they were made to be indifferent as to which
3 long distance carrier their customers might individually select. Section 271 replaced the MFJ
4 long distance "line of business" restriction with a process by which BOCs could enter the "in-
5 region" long distance market, provided that they implemented a series of specific measures that
6 would have the effect of irreversibly opening their previously monopolized local telecommuni-
7 cations markets to competitive entry. To the extent that the local market itself becomes compe-
8 titive, the BOCs' ability to exert market power in the adjacent long distance market would be
9 attenuated. Conversely, if a BOC such as Verizon is allowed to offer in-region long distance
10 service in a less-than-fully-competitive local market, then the BOC would have the ability to
11 engage in precisely the same type of anticompetitive conduct that the MFJ was intended to
12 prevent

13
14 39 Interactions between the structurally separated BOC and long distance entities with
15 respect to the use or provision of common or shared resources must conform to a set of five
16 conduct provisions set out at Section 272(b), which require that the BOCs long distance
17 affiliate

18
19 (1) shall operate independently from the Bell operating company;

20
21 (2) shall maintain books, records, and accounts in the manner prescribed by the
22 Commission which shall be separate from the books, records, and accounts
23 maintained by the Bell operating company of which it is an affiliate;

1 (3) shall have ~~separate~~ officers, directors, and ~~employees~~ from ~~the~~ Bell operating
2 company of which it is an affiliate:

3
4 (4) may not obtain credit under ~~any arrangement that~~ would ~~permit~~ a creditor.
5 upon default, to have recourse to the ~~assets~~ of the Bell operating company: and

6
7 (5) shall conduct all transactions with the Bell operating company of which it is an
8 affiliate on an ~~ann's~~ length basis with any such ~~transactions reduced to~~ writing
9 and available for public inspection.

10
11 40 What Congress has done is to ~~create~~ a transition between the outright prohibition of
12 long distance entry that had prevailed under the ~~MFJ~~ with a transitional separate affiliate
13 mechanism that could be extended by the FCC beyond the ~~minimum~~ three-year period." ~~so~~ as to
14 provide safeguards against BOC anticompetitive conduct that had been unnecessary under the
15 pre-1996 MFJ "line-of-business" outright prohibition against long distance entry." The Section
16 272(a) and (b) separate affiliate requirements serve ~~two~~ separate objectives:

17
18 (1) By requiring that the long distance affiliate "operate independently" vis-a-vis the BOC
19 ILEC entity, the BOC is limited as to the extent to which it can confer any unique
20 competitive advantage, arising from its incumbency and ~~certain~~ potential economies of

54 47 U.S.C. §272(f)(1).

55. See footnote 52, *supra*.

1 network integration, upon its affiliate long distance entity to the detriment of
2 nonaffiliated IXCs: and
3

4 (2) By requiring that the details of inter-affiliate transactions and transfers of assets and
5 services be made at fair market value, posted on the BOCs website, and ultimately
6 subject to periodic audit. BOC conduct that is inconsistent with the statute is made more
7 easily detectable than it would be if the BOC were permitted to conduct its largely
8 monopolistic local and competitive long distance businesses on a fully integrated basis.
9

10 41. In its comments to the FCC, Verizon (for the first time) advanced its position that the
11 Section 272 sunset provision applies on an "all or nothing" basis: that is, if the 3-year sunset is
12 permitted in New York, then the separate affiliate safeguards would cease to apply in all Verizon
13 states, regardless of whether or nor each state has even obtained interLATA authority.⁵⁶ If the
14 FCC adopts Verizon's interpretation of the federal statute, and absent an extension of the current
15 three-year sunset, then Verizon would have no obligation to abide by any of the safeguards
16 included in Section 272 for any of its BOCs in any Verizon states after December 2002. This
17 would, of course, include Verizon DC. As such, this Commission would lose a valuable tool
18 for exposing cross-subsidization and other anti-competitive activities.
19

20 42. If Verizon's position in current FCC proceedings is adopted, the District will not benefit
21 from even this superficial separation between the Verizon local services and the long distance

56. *In re Matter of Section 271(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, *Comments of Verizon, August 5, 2002*, at 3-6.

offerings. **On** May 24, 2002, the FCC issued a Notice of Proposed Rulemaking in WC Docket No. 02-112 regarding the sunset of the separate affiliate “transitional” requirements under Section 272 as they apply to Bell Operating Companies.⁵⁷ Through the Notice, the FCC seeks comment on (1) whether the structural safeguards put in place should be extended beyond the 3-year period identified in the statute, and (2) whether any alternative safeguards should be put in place in states where the statutory requirements have sunset.⁵⁸

43. Transactions and other interactions between the state-regulated BOC ILEC entity and the Section 272 long distance affiliate will necessarily have an impact upon the financial condition of the regulated entity. State commissions have long been concerned with inter-affiliate transactions involving utilities subject to their jurisdiction. The five elements of the Section 272(b) code of conduct clearly address these types of concerns.

44. The FCC has recognized and acknowledged that, where the policies of a state place more stringent competitive requirements on a BOC than those of the federal statute or the FCC, the State has the authority to enforce those requirements. TA96 confirms that states have authority beyond the requirements of the federal Act. Section 253(b) states:

⁵⁷ In the Matter of Section 271(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, Notice of Proposed Rulemaking, 17 FCC Rcd 9916 (2002) (“Notice”).

⁵⁸ Notice, 17 FCC Rcd 9917

(b) STATE REGULATORY AUTHORITY—Nothing in this section shall affect the ability of a State to impose ~~on~~ a competitively ~~neutral~~ basis and consistent with section 254, requirements ~~necessary~~ to ~~preserve~~ and advance universal service, ~~protect~~ the public ~~safety~~ and ~~welfare~~, ~~ensure~~ the continued quality of telecommunications services, and ~~safeguard~~ the rights of consumers.

The FCC has found, in the *Non-Accounting Safeguards Order*, that a state Commission has the authority to impose on BOCs seeking 271 authority ~~any~~ requirements it ~~deems~~ necessary ~~shon~~ of denial of entry into the interLATA market.⁵⁹

45. One such “requirement” necessary to ~~preserve~~ and advance universal service, protect the public safety and welfare, ~~ensure~~ the continued quality of telecommunications services, and safeguard the rights of consumers” concerns the ~~treatment~~ of Verizon customers who do not pay amounts billed by Verizon on behalf of long distance carriers. It is my understanding that under current PSC rules, Verizon is prohibited from disconnecting the customer’s basic local exchange service in the case of such ~~non-payment~~.⁶⁰ Verizon may, of course, disconnect the customer’s service in the event of non-payment of *Verizon’s* charges. If Verizon were to integrate its long distance and local exchange services businesses into the Verizon DC entity, then charges for Verizon long distance services would no longer be on behalf of a separate entity (*i.e.*, Verizon Long Distance), but would instead become *Verizon DC* charges. If, under these circumstances, Verizon DC were to acquire the ability to disconnect a customer’s *local* service for non-payment

59. *Non-Accounting Safeguards Order*, 11 FCC Rcd 21929.

60. Formal Case No. 988, *In the Matter of Development of Universal Service Standards and the Universal Service Trust Fund of the District of Columbia*, and Formal Case No. 962, *In the Matter of the Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Act of 1996*.

1 of a Verizon *long distance* bill, Verizon DC (as a long distance provider) would be acquiring a
2 significant competitive advantage over nonaffiliated IXCs, whether or not those Carriers utilize
3 Verizon's billing and collection services. This **disparity in treatment** should not be permitted,
4 and the Commission should require that Verizon treat its own long distance customers in exactly
5 the same manner as it is required to treat competitor customers with respect to disconnection of
6 service for non-payment of long distance charges.

7
8 46. The FCC's *Non-Accounting Safeguards Order* clarifies the intent of the 1996 Act and
9 gives the FCC full authority to grant *rights of entry* interLATA authority, including intrastate
10 interLATA authority:

11
12 In this regard, based on what we find is clear congressional intent that the
13 Commission is authorized to make determinations regarding BOC entry into
14 interLATA services, we reject the suggestion by the Wisconsin Commission
15 that, after the [FCC] has granted a BOC application for authority under section
16 271, a state nonetheless may condition or delay BOC entry into intrastate
17 interLATA services.⁶¹

18
19 However, while the FCC affirmed its authority to grant interLATA entry, the Wisconsin
20 Commission's concerns as presented in its reply comments in the *Non-Accounting Safeguards*
21 proceeding "respecting universal service, public welfare, service quality and consumer
22 safeguards, or section 271(c), respecting state advancement of competition beyond federal
23 minimums," were not dismissed. Instead, the FCC expressly held that "a state would retain

61 *Non-Accounting Safeguards Order*, 11 FCC Rcd 21929, footnotes omitted.

62 *In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and*
(continued...)

1 authority to enforce obligations relating to a BOC's provision of intrastate interLATA service,
2 such as those identified by the Wisconsin Commission, through mechanisms other than denial or
3 delayed of [sic] entry into the intrastate interLATA market.⁶³ Thus, all authority in limiting or
4 placing obligations upon BOC provision of intrastate interLATA service remains with the state.
5 and it is the duty of the state commission to consider whether additional restrictions on Verizon's
6 activity are necessary to protect competition in the local and intrastate interLATA market. Of
7 course, due to its unique geography, no intrastate interLATA calls can originate from DC.
8 Nevertheless, the DC Commission retains authority with respect to the operation the Verizon
9 Bell Operating Company's local service in the District. Where this Commission finds the
10 potential for and evidence of local service being used to cross-subsidize competitive long
11 distance offerings, the proper allocation of revenues and expenses between competitive and non-
12 competitive services is squarely within the DC Commission's jurisdiction.

13
14 47 The Congressional purpose for the separate affiliate requirement is not served if all that
15 the requirement entails are nominal bureaucratic constructs easily "satisfied" by the BOC and its
16 272 affiliate by merely maintaining facial separation. Yet on the basis of the affiliate agreements
17 entered into by Verizon and its Section 272 Affiliates, the pricing plans offered by Verizon Long
18 Distance, as well as the reponed results of the first Verizon New York 272 Audit, it is now
19 evident that Verizon seeks to interpret and to apply the separate affiliate requirement in precisely

62 (continued)

272 of the *Communications Act of 1934, as amended*. CC Docket No. 96-149. Reply *Comments*
of the *Public Service Commission of Wisconsin*, at 7.

63 *Non-Accounting Safeguards Order*, 11 FCC Rcd 21929, footnote 97.

1 that superficial a manner and, wherever possible, to conduct the various inter-affiliate business
2 transactions and relationships *as if the separate affiliate requirement did not exist*.

3
4 48. By ignoring Section 272 *in practice*, the BOCs **are** able to **render** meaningless the
5 crucial safeguards provided by the **statute**. **As** I have previously noted, the purpose of the
6 Section 272(a) separate affiliate **requirement** and the Section 272(b) code of conduct **was and is**
7 to forestall the potential for discriminatory and anticompetitive conduct arising out of the ability,
8 as an *economic matter*, for the BOC to extend its market power in the *local* telecommunications
9 market into the adjacent long distance market. Prior to **granting** any BOC's application for
10 Section 271 authority, the FCC found that Section 272 contains all the necessary elements to
11 constrain BOC exercise of this market power? **however**, empirical evidence from states with
12 Section 271 approval indicates that, as currently applied, Section 272 fails to prevent **discrim-**
13 **ination** and anti-competitive conduct by the BOC on behalf of its long distance affiliate.

14
15 49. Assuming that the FCC does not adopt Verizon's 272 "BOC by B O C Sunset position
16 this Commission will have ongoing authority to review and evaluate the **measures taken by**
17 Verizon to comply with the Section 272 safeguards. **As** a means for ensuring that a BOC **main-**
18 **tains** the appropriate competitive safeguards **after** receiving Section 271 authority, the **Act sets**
19 out various **structural** and procedural requirements at Section 272. **Enforcement** of these safe-
20 **guard>**, provided for under Section 272(d), requires a joint federal/state biennial audit. The **Act**

64 *in the Matter of Regulatory Treatment of LEC Provision of Interexchange Services
Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate,
Interexchange Marketplace*, CC Docket No. 96-149, 96-61, *Opinion*, Rel. April 18, 1991, 12
FCC Rcd 15756, 15763.

1 specifically requires that, when reviewing the audit, the states consider "particularly whether
2 such company has complied with the ~~separate~~ accounting requirements under subsection (b)."⁶⁵
3 Considering this Commission's authority in reviewing **Section 272** compliance **two** years **from**
4 now (in the event that Verizon obtains **Section 271 authority** at this time), the Commission **needs**
5 to consider, **at this time**, Verizon's plans for compliance **with** the requirements of **Section 272 as**
6 these will apply during the time period between now and the completion of the first biennial
7 audit. Verizon DC should not be allowed a "free ride" during the critical ~~first~~ **years** of its
8 interLATA operation, at most promising some **son** of vague after-the-fact compliance in its
9 dealing with those CLECs that are by that time still active in the market.

10
11 50. Section 271 approval in other Verizon states *does not* indicate that the Company has
12 satisfied the requirements of Section 272. The federal statute states that **to** receive long distance
13 authority, the FCC must be convinced that the BOC *will* apply the separations requirements of
14 Section 272.⁶⁶ **This intent is** then tested by the Biennial Audit, and it is the opinion of the
15 federal-state joint review of the audit report that determines whether the BOC is *in fact* in
16 compliance **with** Section 272.⁶⁷ The factual evidence presented by the Verizon audit report for
17 New York is thus more probative **as to** Verizon's *actual practices* and more applicable to this

65 47 C.S.C. §272(d)(1).

66 47 U.S.C. §271(d)(3)(B)

67 The FCC states that "... the audit **is** being conducted to satisfy the Commission and the state public service commissions that the prescribed non-structural and accounting safeguards have been implemented and are working." Accounting *Safeguards Order*, 11 FCC Rcd 17630.

1 proceeding than any prior claims **that** the FCC has "previously approved" the Verizon
2 implementation of Section 272.⁶⁸

3
4 51. This Commission must ensure that Verizon DC **does** not go the way of the other
5 Verizon operating companies and allow it to circumvent the Section 272(b) requirement through
6 superficial measures to comply with the separations requirements. **Absent** proper compliance in
7 the manner intended by Congress and the **FCC**, consumers and competitors will have no
8 protection against anticompetitive conduct on the **part** of Verizon.

9
10 52. By its decision not to include a specific Section 272 compliance plan as **part** of its
11 Section 271 application in DC, Verizon has obviously sought to sidestep this issue. However,
12 despite Verizon's silence, there is in fact significant evidence upon which this Commission can
13 draw regarding Verizon's implementation of Section 272.

14
15 53. Verizon has gained Section 271 authority in eight in-region states. Verizon **received** its
16 Section 271 authority in **New** York approximately 33 months ago. Verizon's other applications
17 to the FCC have specifically **represented** that Verizon intends to comply with Section 272 in the
18 same manner as has been accepted in other Verizon **states**.⁶⁹ Verizon has indicated that it **intends**

68 In response to **OPC 1-8**, Verizon DC confesses that "in order to demonstrate its future compliance with section 272, Verizon DC expects that it will provide a declaration similar to the one that it has filed in other states"

69 See e.g. Application by Verizon **New** England for Authorization to Provide In-Region, InterLAT.4 Services in Massachusetts, CC Docket No. 00-176 (filed Sept. 22, 2000) at 55-58; Verizon Massachusetts I Browning Decl. at paras. 7, 10(b), 10(c), 11, 12(a), 12(b), 12(c), 13, 14,

(continued...)

1 to make the same statement for DC **when** filing **with** the FCC.⁷⁰ Verizon **has** **stated** that it **is** its
2 policy to enter into global contracts for services **between** the Verizon operating companies and
3 Verizon Long Distance, filling in the details for a **specific** jurisdiction **when** Verizon's appli-
4 cation is **granted**. This practice clearly indicates the Verizon **intends to contract** for the **same**
5 services, under the **same** terms and conditions, in DC **as** in the other **Verizon** in-region **states**.
6 The Commission should **therefore** consider evidence of Verizon's conduct in other jurisdictions
7 as indicative of Verizon's plans for the District.

8
9 54. The timing **of** Verizon's DC application affords this Commission the opportunity to
10 examine not just a promise to implement Section **272** in the **m** **e** manner **as** in all other Verizon
11 states, but also to examine the **effectiveness** of that implementation. In February of this year,
12 Verizon New York filed its unredacted Section **272** Audit Report **as** required by Section **272(d)**.
13 Unfortunately and as a result **of** specific actions by Verizon with respect to the release of the
14 New York audit report,⁷¹ it is extremely unlikely that the proceeding to review the first Verizon
15 New York audit will **be** completed by the time Verizon files its second Audit **report**.
16 Considering these delays in implementing Section **272** through the Audit proceedings, this

69. (...continued)
22-26, 29 & Attachments **B. D. F. G. H. K. J. M. P. 2.**

70 Verizon DC response to OPC **1-8**

71. The FCC has ordered that the first audit should be conducted during the first year of a state's Section 271 authority. *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket **96-150, Order**, January 10, 2002. However, Verizon's filing of a redacted version, followed by its delay in responding to requests that the unredacted report be made available either publicly or under protective agreement, culminated in an FCC Order forcing Verizon to make public the unredacted report.

Commission should give **effect** to the New York audit **report** and to **other** information **regarding** Verizon's inter-affiliate conduct in New York in **assessing** Verizon's potential conduct in DC.

55. Based upon the various Verizon Section **272(b)(5)** affiliate transaction postings and service offers provided on the companies' website⁷² and the first Verizon Section 272 Audit report for New York,⁷³ it is **apparent** that the various **interactions** between the BOC and the Section 272 long distance affiliate raise serious questions as to the **actual, de facto** extent of "separation" that prevails in practice as between the two **supposedly separate** corporate units. A significant portion, although by no means all, of these interactions relate in **some** manner to activities associated with the "joint marketing," joint **account** administration, and combined billing of the BOCs' local and **long** distance services. Each of **these** activities is undertaken by the BOC and its affiliate as if, for all practical **purposes**, Section **272** did not exist.

Verizon has failed to comply with the specific requirements of Section **272(b)** with respect to activities involving the "joint marketing" of local and long distance **services**.

56 A BOC's ability to engage in joint marketing of its **own** local services with its affiliate's long distance service is found at Sections **272(g)(2)** and (3) of the **19% Act**:

72. <http://www.verizonld.com/regnotices/index.cfm?OrgID=1>, accessed 9/25/02

73. *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards under the Telecommunications Act of 1996*, CC Docket No. 96-150, Reports of Independent Accountants on Applying Agreed-Upon Procedures, prepared by PricewaterhouseCoopers LLP, filed June 11, 2001 and June 18, 2001 ("New York 272 Audit Report")

1 272(g)(2): BELL OPERATING **COMPANY SALES** OF AFFILIATE
2 **SERVICES**- A Bell operating company **may** not market or sell **interLATA**
3 service provided by **an** affiliate required by this section within **any** of **its** in-
4 region States **until** such company is **authorized** to provide **interLATA** services
5 in such State **under** section 271(d).

6
7 272(g)(3): RULE OF CONSTRUCTION- The joint marketing and sale of services
8 permitted under this subsection shall not be **considered** to violate the
9 nondiscrimination provisions of subsection (c).

10
11 The "nondiscrimination provisions" being referred to here are found at subsection (c)(1) of
12 Section 172:

13
14 (c) NONDISCRIMINATION SAFEGUARDS- In its dealings with its affiliate
15 described in subsection (a), a Bell operating company--
16 (1) may not discriminate between that company or affiliate and any other entity in
17 the provision or procurement of goods, services, facilities, and information, or in
18 the establishment of standards.

19
20 But subsection 272(c)(2), which is not superseded by subsection 272(g)(3) (which refers
21 specifically to "the nondiscrimination provisions of subsection (c)") and thus applies to all joint
22 marketing activities as well, states that a Bell operating company

23
24 (2) shall account for all transactions with an affiliate described in subsection
25 (a) in accordance with accounting principles designated or approved by the
26 Commission.

27
28 The *Telecommunications Act* thus does not **so** much *permit* BOC joint marketing of its affiliate's
29 long distance service after having received Section 271 authority, but rather does not **expressly**
30 prohibit it. Rather, the *Act* merely sanctions the operation of a BOC, having satisfied the
31 requirements of Section 271(c), to enter into the long distance arena and to jointly market its

(local) services with the long distance services being offered by the Section 272(a) affiliate. subject to all of the separate affiliate provisions set forth at Section 272(b). *Nothing in subsection 272(g)(3) in any way exempts Verizon or its Section 272(a) interLATA affiliate Verizon Long Distance from the requirements of Section 272(b) with respect to any "joint marketing" activities.* As such, all joint marketing activity must be performed on an "arm's length" basis, and the long distance affiliate must pay the BOC fair market value for all joint marketing services.

57. Disclosures and postings that Verizon has been required to make with respect to Section 272(b) affiliate transactions confirm that, in other jurisdictions, Verizon does not pay fair market value for joint marketing services. According to Verizon's Section 272(b)(5) disclosures, Verizon Long Distance's "payments" to Verizon New York for customer acquisition/joint marketing services are only \$7.71 per contact." Verizon Long Distance has already contracted with Verizon DC for Verizon DC to perform joint marketing for business customers for between \$118.07 and \$2,464.95 per sale (price depends on service sold)." The magnitude of such payments is woefully short of the fair market value of these services and of the customer information that is being beneficially furnished by the BOCs to their affiliates.

74 <http://www.verizonld.com/pdfs/Exhibit46zhAmendment34.pdf>, accessed 09/25/02.

75 Verizon Long Distance has contracted with Verizon DC for the BOC to provide "sales, Ordering and Customer Inquiry Service for certain large business services. These services include: "sales negotiation and acquisition: account planning, all presale customer meetings, strategy sessions, and solutions design: costs of custom bid development and presentation; service order processing; systems maintenance for ordering, pricing, electronic product references; verification of product availability; error correction for orders; and sales retention attempts." See <http://www.verizonld.com/pdfs/imaam38vld1Rates.pdf>.

58. Currently, Verizon improperly prices joint marketing services (including business joint marketing services already under contract in DC)⁷⁶ using Fully Distributed Cost methodologies instead of Fair Market Value. The Section 272 Audit of Verizon New York revealed that Verizon made no attempt to estimate a fair market value for its inbound channel.⁷⁷ despite the Commission's explicit requirement that the BOCs do so:

While we decline to specify the methodologies that carriers must follow to estimate fair market value, we do set the baseline for a good faith determination of fair market value by requiring carriers to use methods that are routinely used by the general business community. For example, when carriers can estimate the market value of transactions using independent valuation methods, carriers should apply such methods to ascertain fair market value. Depending on the type of transaction, examples of methods for determining fair market values for both assets and services include appraisals, catalogs listing similar items, competitive bids, replacement cost of an asset, and net realizable value of an asset. We agree with GTE that sales to third parties can provide a benchmark and we conclude that if sales to third parties of a product at a particular price generate large revenues then the sale price is strong evidence of a good faith estimate of fair market value. When situations arise involving transactions that are not easily valued by independent means, we require carriers to maintain records sufficient to support their value determination. Specifically, the valuation method chosen by the carrier must succeed in capturing the available supporting information regarding the transaction and must utilize generally accepted techniques and principles regarding the particular type of transaction at issue. We note that nothing discussed here exempts carriers from their statutory obligation under section 220(c) to justify their accounting entries.⁷⁸

⁷⁶ *Id*

⁷⁷ *New York 272 Audit Report*, Appendix A, at 21

⁷⁸ *Accounting Safeguards Order*, 11 FCC Rcd 17610.

1 Instead of conducting the required study and estimating the inbound channel's value. Verizon
2 presented the Section 272 Auditors with a letter stating that "FMV could not be obtained for
3 these services." Verizon fails to explain why it did not obtain an estimated fair market value
4 for these services.

5
6 59. Verizon can certainly estimate a fair market value for joint marketing services. In fact,
7 Bell South has attempted to do so in its inter-entity pricing.¹⁰ In short, the "fair market value" of
8 an asset or a service is what the buyer of that asset or service would be willing to pay to acquire

79. Verizon Communications Inc. Section 272 Biennial Agreed-Upon Procedures
Engagement, filed in the Matter of Implementation of the Telecommunications Act of 1996:
Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket No. 96-150,
Filed February 6, 2001. Appendix A at p. 21.

80. Marketing and Sales Agreement Between BellSouth Telecommunications, Inc. and
BellSouth Long Distance, eff. 5/2/02. Schedule A. Section 5.1., available at
<http://bellsouthcorp.com/policy/transactions/ms5202.pdf>, accessed 09/25/02. Bell South charges
BellSouth Long Distance the following for joint marketing services:

Unless otherwise specified in this Schedule A, the price for all functions and services
specified by this Schedule A is as follows: ten percent (10%) of the amounts billed to end
users of BSLD's Products and Services sold by BST pursuant to this Agreement. Such
billing may be done either through BSLD as a Billing and Collections clearinghouse
customer of BST, or otherwise through BSLD directly or through any other party or means.
Such billing shall, however, be net of billing adjustments Universal Service Fund charges
and other similar charges. For purposes of this Section, the term "Billing Adjustments" shall
be defined as amounts related to the reissuance of incorrect bills, and shall not include
adjustments for fraudulent charges, uncollectibles, or net bad debt.

Although BellSouth claims to price joint marketing services based on fair market value
methodologies, I have not had the opportunity to examine these studies or the amounts paid by
BellSouth Long Distance to BellSouth, and therefore cannot be sure that the amount contracted
for represents a valid estimate of fair market value. BellSouth, however, has clearly found it at
least theoretically possible to apply a fair market value to joint marketing services, which
Verizon has maintained is impossible.

1 it. not what the seller incurs to produce it. **That amount**, in turn, **will** be dictated not **by the**
2 seller's cost, but by what the buyer would have to **spend** to acquire the item in some alternative
3 manner. In an "arm's length" transaction, the seller would **base** its price to the buyer not on the
4 seller's cost, but **on** the buyer's willingness to pay. **Acceptance** by Verizon DC of a payment
5 from Verizon Long Distance that is anything **less than** Verizon Long Distance's "willingness to
6 pay" amounts to nothing **shon of** an outright cross-subsidy flowing from **the BOC** to the 272
7 affiliate

8
9 60. As the California PUC noted, maintenance **of** separate affiliate requirements is **critical**
10 to the CPUC's ability to detect and ultimately **remedy** such **practices**:

11
12 ... Pac-West/WA's costing discussion and comparison regarding the proposed
13 joint marketing plan **demonstrates** cross-subsidization, may exist, [sic] and **we**
14 find it very troubling.

15
16 Accordingly, we will require Pacific to carefully track the time its customer
17 representatives spend marketing PBLD's services regardless of whether the
18 marketing was successful or **not**, and to **routinely** re-examine and **report** this
19 cost element in its affiliate transaction **report** each year. **As** our confidence in
20 non-structural safeguards **has** waned significantly over the **past years**, we will
21 request Commission **staff** to audit Pacific's joint marketing **arrangement** with
22 PBLD as part **of** its next schedule audit in compliance with Section 314.5 and
23 797 ¹⁴⁰⁶. At a minimum, we would expect this audit would verify the
24 creditability of Pacific's time records and resulting cost allocations to PBLD.
25 **We** will require Pacific to pay for all costs associated with this audit (and
26 allocate them appropriately to PBLD), including reimbursements to the
27 Commission for any audit consultant fees **incurred**. Should the audit uncover
28 cost allocation or other improprieties from the joint marketing arrangement
29 between Pacific and PBLD, we will not hesitate to take the strongest action.
30 **As** staffing permits, Commission **staff** may also seek to **participate** with the
31 **FCC** on accounting safeguard audits covering joint marketing issues **between**
32 Pacific and PBLD. ¹⁴⁰⁷

1 **The** record before **us** simply does not **support** the finding that **there** is no
2 possibility of improper cross-subsidization anywhere within Pacific's proposal
3 to provide long distance telephone service within California. Rather, the
4 record includes documents that purport to show **compliant** costing allocations
5 as well **as** documents that purport to show **inappropriate allocations** and
6 underlying methodology. **As** of this **dare**, the **mandated audits** have not yet
7 been performed. **However**, we **do** find that **our requirements** for separate
8 accounting records and for the examination of the **cost allocation** methodology
9 for the provision of **intrastate interexchange telecommunications service**,
10 pursuant to our affiliate transaction and cost allocation **rules and O.P. 8 and 18**
11 of **D.99-02-013,⁽⁴⁰⁸⁾** will be **integral** in **preventing**, identifying and eliminating
12 improper cross-subsidization.']
13

14 61. There are also extensive information flows going from the BOC entity to the long
15 distance affiliate, and that the affiliate, for which the affiliate is not required to pay anything
16 remotely close to the full and fair market value. For example, Verizon operating companies
17 provide their long distance affiliate with unfettered access to the Verizon *local* customer base
18 and to the inbound customer-initiated contacts that arise **as** a consequence of Verizon's dominant
19 control of the residential local service market in every in-region Verizon state. Competing long
20 distance providers must engage in extensive advertising, direct mail, and telemarketing to
21 promote their service, and do not get anywhere near the quantity of inbound customer contacts **as**
22 does the BOC, and those which IXC's do receive are primarily the result of the IXC's advertising
23 and other promotional efforts, undertaken at considerable cost to **those** IXC's.
24

25 62. Customer acquisition is among the most costly aspects of an interexchange carrier's
26 operation. Without the benefit of the embedded ubiquitous customer base that is uniquely
27 available to Verizon Long Distance, other IXC's must pursue active marketing strategies

81. *Calif. PUC Decision*, at 257-258, footnotes omitted.